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We Get Questions

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We answer client questions about current economic issues including US Federal Reserve (Fed) monetary policy, China's growth forecasts and the much-expected recession that hasn't happened yet.

What impact could the Israel-Hamas war have on the global economy?

The conflict in Israel and Gaza is a humanitarian tragedy and an adverse shock to the world economy. In our view, the negative shock is more about supply than demand, thereby adding to inflationary pressures because it imperils energy supplies. The risks become more severe if the situation escalates and draws in Iran or Saudi Arabia, both major oil producers.

The global market reaction so far is mainly expressed through a risk premium for energy prices. The Middle East's share of world economic output is modest, with the entire region accounting for less than 5 percent of global gross domestic product (GDP), according to the International Monetary Fund (IMF). However, it has an outsized footprint in global energy production. The euro area economy is more exposed than the US to reverberations, given its geographic proximity and ongoing shift away from a reliance on Russian energy.

Is global recession still in the cards? The US looks better, and China looks weaker.

We believe policy firming by the Fed makes the economy more susceptible to adverse shocks. Indeed, in five of the past six episodes of sustained Fed tightening, the US economy fell into recession. Thus far, we have avoided a downturn. We believe this time might be different because households set aside cash from generous fiscal transfers during the pandemic, excess in real estate has been slowly trimmed and financial conditions have not firmed nearly as much as the Fed's policy rate.

Past performance, however, does not necessarily indicate future outcomes. In our view, the risk of recession remains elevated as long as Fed policy remains restrictive, which will probably be so for the next year. Adverse shocks abound, including a potential government shutdown that has only been deferred, industrial strikes, the snapback in student loan obligations and a spike in global energy prices. One, or a combination of several, has the potential to tip a vulnerable US economy into recession.

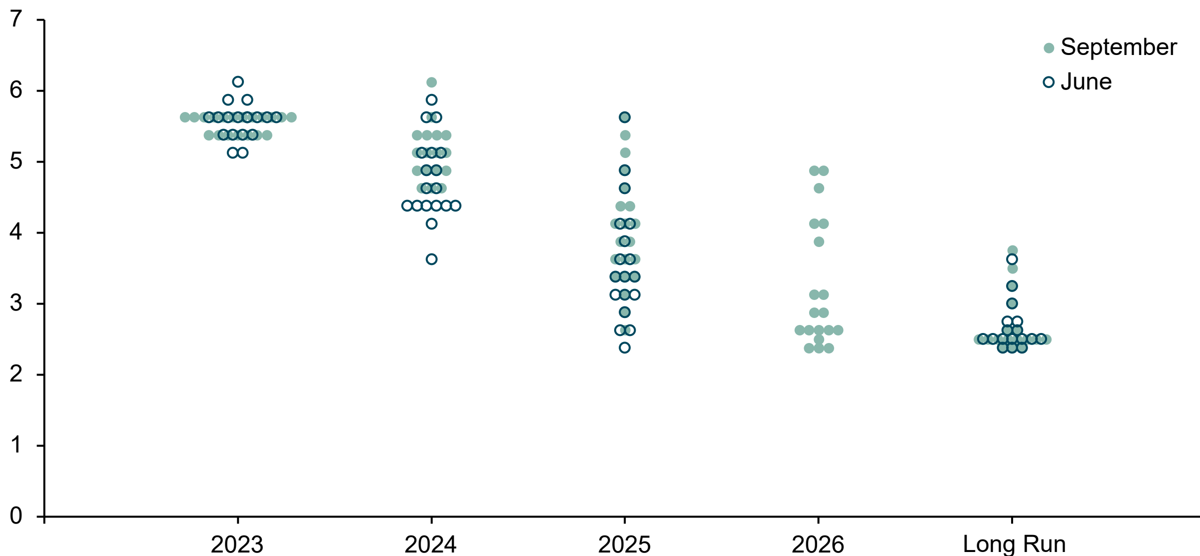
In prior years, strong economic growth in China pulled along many of its trading partners and cushioned global growth from problems in advanced economies. Now, China has issues of its own, including massive retrenchment in property development, a return to more state control of key industries and a shrinking world market given mistrust about its foreign policy intentions. We feel that without the Chinese cushion, a contraction in the US has more scope to spread.

When will the Fed start easing and by how much?

The monetary policy strategy of the Fed has been pared down to basics in light of uncertainties about economic regularities and inflation dynamics after the pandemic. We believe Fed Chair Powell and company intend to raise the nominal funds rate to an obviously restrictive level and hold it there until enough evidence accumulates that inflation will fall back to goal. Having tightened policy at a torrid pace (relative to experience) over the past one and a half years, the nominal fed funds rate is close to, or even at, that restrictive plateau. We think they will hold the policy rate at 5¼ percent through Fall 2024.

Appropriate Level of the Target Funds

At year end, midpoint, percent



For illustrative purposes only. Level variables—the unemployment rate and the Fed funds rate—are measured as their averages in the fourth quarter of each year. Growth rates—real GDP and inflation—are the four-quarter change ending in the fourth quarter. Source: Federal Reserve, accessed 9/20/23. Dots represent each Federal Open Market Committee (FOMC) participant.

The Fed's Summary of Economic Projections conveys this resolve. The 19 participants in the Fed policy meetings report the policy rate appropriate for the next few years, as in the chart on the previous page with the solid dots plotting the September submission and the open ones those from June. The majority foresee one more tightening this year and only a slightly lower rate one year later, consistent with a policy pivot that is modest and late in coming. This cluster of dots shifted up about ½ of a percentage point in the past three months. Economic activity is a bit more vigorous and inflation more stubborn than officials previously suspected. As a result, we feel "high for long" must be both higher and longer to return inflation to the Fed's 2-percent goal. Whether this has fully sunk into the understanding of investors yet is doubtful.

Is the banking crisis really over? What was the aftermath?

When it comes to strains in the banking system, it is not over until the Fed says it's over. A main channel of the monetary transmission mechanism is through bank balance sheets. Each time the Fed raises its policy rate, bank deposits become less attractive relative to market instruments, and banks lose deposits. With less of that secure funding, they cut back on securities holdings and lending. At the same time, longer-term assets held by banks, such as Treasury securities and fixed-rate mortgages, suffer capital losses, necessitating commensurate balance-sheet shrinkage.

The Fed has undergone its most aggressive policy firming in 40 years, raising the overnight rate 5¼ percentage points since March 2022. Over that period, core deposits in the banking system shrank 9½ percent, and longer-term Treasury securities posted two consecutive years of capital losses.

As long as the Fed keeps policy firm, banks will be under pressure, but it will likely not be the fast-and-furious kind of March that led to the closure of two large regionals. Management has had time to batten down the hatches and diversified institutions, including the largest banks, should weather the continuing Fed storm.

Does the US sovereign rating downgrade matter or not? Can we compare it to what happened in 2011?

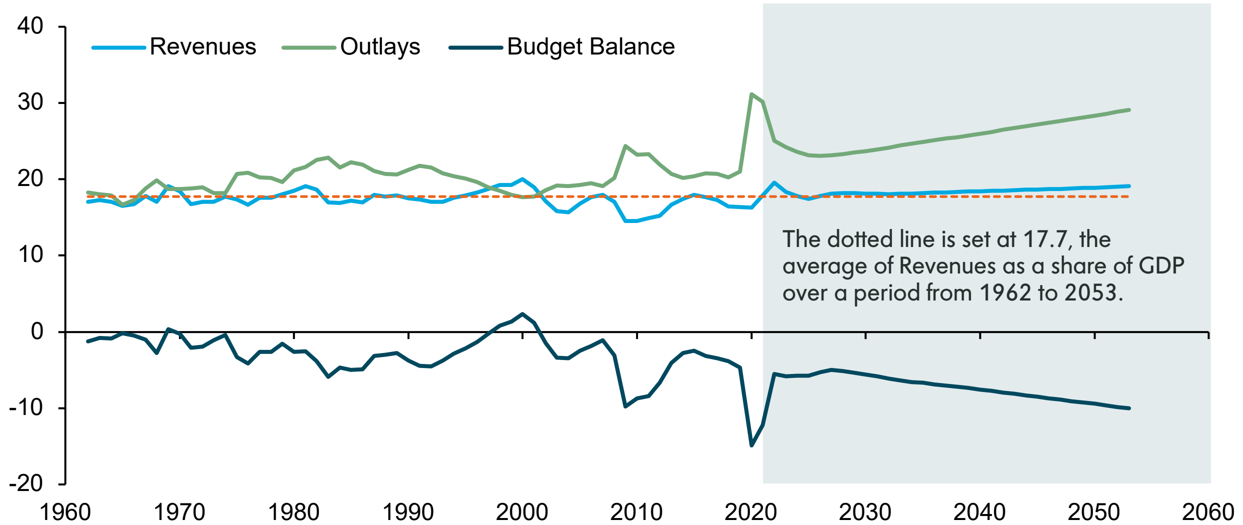
When a contractor finds water damage in the attic, it is not necessarily a sign that the house will collapse imminently. Rather, a pernicious problem has been identified that, if left unremedied, ultimately spells ruin. The same is true of downgrades of the US sovereign rating by Fitch this August and Standard and Poor's 12 years earlier. Both were warnings about the process and path of federal budgeting.

In our view, the process by politicians in Washington DC has become dysfunctional. Congress passed a budget on time on only four occasions in the past five decades, the government shut down three times in the past 10 years and there have been multiple threats of default with dallying over the debt-ceiling deadline.[1] The ratings agencies rightly worry we are not organized enough to pay our bills on time.

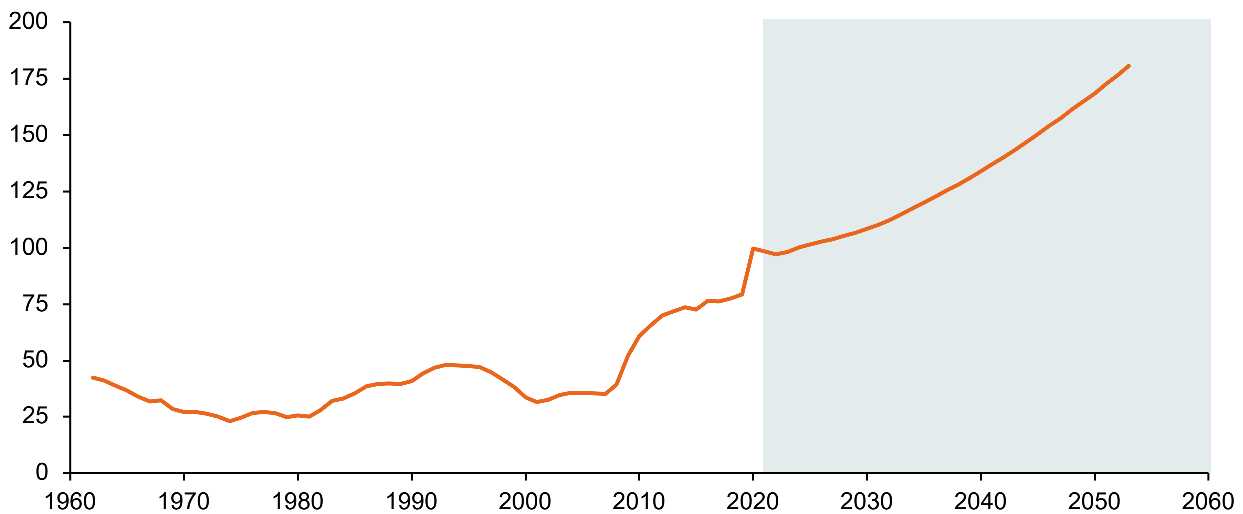
The potential problem escalates as our bills mount, which is about the budgetary path. Net government debt is already greater than nominal GDP, a circumstance previously only seen after world wars. According to the Congressional Budget Office, net debt will exceed 175 percent of nominal income in a generation, as in the lower panel of the chart on the following page. The budget arithmetic isn't complicated, as in the upper panel. Revenues are a steady 18 percent of nominal GDP. Outlays relative to GDP started above that this decade, registered a marked countercyclical increase in recession that was never taken back and grow with entitlements and interest payments thereafter. The debt increases at an accelerating rate as long as politicians are unwilling to touch structural policies driving revenues and entitlements.

The rating agencies rightly worry that investors will become increasingly fretful over the dripping sound in the attic. The sound will get more insistent if the government shuts down again this year, which would likely lead the ratings agencies to sound more alarms.

Federal Budget
Relative to nominal GDP, percent



Net Government Debt
Relative to nominal GDP, percent



Source: CBO, "The Budget and Economic Outlook" (February 2023) and "The 2023 Long-term Budget Outlook" June 2023. Accessed 9/22/2023.

What does Congressman Kevin McCarthy's ouster mean for the federal budget and US economy?

We believe the ongoing melodrama over choosing the next Speaker of the House highlights how far the budgetary process has gone off track. According to many reports, the incumbent, Kevin McCarthy, was ousted because he arranged a bipartisan deal to avert a government shutdown. In our view, this sends a clear message that the smooth operations of the government and the budget are low political priorities.

Until his successor is settled, no legislation can be passed by the Congress. This includes a budget resolution to avert a shutdown in November. Once his successor is settled, we doubt that a cooperative solution to avoid a shutdown is likely.

We believe investors and rating agencies will take note of this dysfunction to the detriment of the credit standing of the US government.

Why is China's economy slowing? Has it hit a bottom?

China's economy is entering an era of slower growth. We believe it is made worse by poor demographics and a geopolitical rift with many of its trading partners. Growth will average between 4 and 5 percent, much lower than in the past.[2]

One main factor behind the slowdown is a weak real estate sector. This sector, once a major driver of growth at almost one-third of output, has shrunk rapidly. In August, year-to-date property investment is down 8.8 percent, residential property sales down 25 percent and construction starts down 24 percent.[3] The People's Bank of China (PBOC) has delivered some modest easing to support the economy, with lending rates lowered 20 basis points and reserve ratios eased. Some quasi-fiscal easing has also been rolled out, targeting the real estate sector. These policies have begun to gain some traction and have helped the economy find some footing; however, they lack the thrust to drive a strong recovery in 2024. The future scope of monetary easing is limited as the central bank does not want a repeat of the capital outflow episode of 2015.

Activity indicators in September, such as the manufacturing purchasing managers' indexes (PMIs), show the data bottoming out after a downward spiral for most of this year. That said, growth will struggle to reach a 5-percent pace in 2024.

Inflation is back above 2 percent in Japan. Is the Bank of Japan (BoJ) going to raise rates?

Conditions are almost in place for the BoJ to remove its negative policy rates. The annual rate of inflation has come in above 2 percent since April 2022. In our view, inflation expectations are rising, firms appear more comfortable passing along costs and wage gains have momentum. In July, the BoJ relaxed its yield curve control program and signaled that it would tolerate raising longer-term rates provided that it is consistent with macro fundamentals. Before raising the policy rate, however, the BoJ will want strong evidence that 2-percent inflation can be sustainably achieved. We think the BoJ will have greater visibility on 2024 wage agreements at the start of next year that will instill confidence and enable gradual tightening through 2024.

Vincent Reinhart
Chief Economist & Macro Strategist

Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Nicholas Tocchio
VP, Global Economist

Nick is a global economist who helps develop the firm’s views on global macroeconomics. Previously, Nick contributed to global fixed income investment strategy at Standish Mellon Asset Management, a BNY Mellon company.

Nick holds a BA in Economics from Hamilton College and has been in the investment industry since 2013.

Endnotes

[1] DeSilver, D. (September 13, 2023). Congress has long struggled to pass spending bills on time. Accessed at: https://www.pewresearch.org/short-reads/2023/09/13/congress-has-long-struggled-to-pass-spending-bills-on-time/

[2] IMF World Economic Outlook. Accessed at: https://www.imf.org/en/Publications/WEO/Issues/2023/10/10/world-economic-outlook-october-2023 on 10/17/23.

[3] National Bureau of Statistics of China (August 2023); Bloomberg Intelligence.

Disclosure

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